

The impact and effectiveness of local content policy on oil exploration and production in Brazil

Edmar de Almeida and Diana Martinez-Prieto

Local content policy plays a fundamental role for Brazil. It is through local content policy that the country is seeking to reconcile expansion of the oil sector with its industrial development. Despite the significant evolution of this policy in recent years, several improvements are needed to balance the objectives of promoting industrialization with the competitiveness of oil exploration and production activity in Brazil. Local content policies have an important positive impact on Brazilian industries, particularly the Brazilian shipbuilding industry. At the same time, local content commitments currently represent an important risk factor for exploration and production (E&P) projects in Brazil. The local content commitments are assumed long before the acquisition of product and services for the projects. The risk of cost overruns, delays, and low quality of products is a key consequence of the existing policy, affecting the

attractiveness of Brazil's oil and gas industry. There is a clear space to introduce adjustments in local content policy in Brazil, in order to reduce the potential risks for E&P projects, while still supporting industrialization in Brazil. For future projects, allowing greater flexibility to adjust local content commitments as development plans are established would help reduce project risks. Shifting from an approach that penalizes non-compliance to one that rewards operators who exceed commitments would likely represent a more effective incentive structure. For contracts already signed that are unable to meet local content requirements, there is a range of pragmatic adjustments that could be considered in addition to those already mentioned.

Commitment to local content

The regulation of the oil industry in Brazil has been characterized by a

strong emphasis on promoting local content. The main instruments of local content policy are the commitments to purchase local goods and services made by concessionaires in the bidding rounds for exploration blocks. The percentage of this overall local content commitment is part of the criterion for assessment of offers made in the bidding rounds.

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It is important to note that the commitments made in the bidding rounds become part of the concession contract and apply to the entire period of exploration and field development. In other words, companies commit to buying those Brazilian goods and services that they will need during a period that could last 10 years. In most



cases their needs are not well known, since they depend on the results of the exploratory campaign. Without knowing precisely what goods and services will be needed, or what the Brazilian market conditions will be at the time of purchase, the commitments of local content become very relevant economic risks for oil projects.

Certification and compliance process

The methodology for establishing local content commitments by operators and for certifying local companies has evolved significantly over time. In the first six bidding rounds, rules for certification were relatively flexible. As the government increased the importance of local content in auctions, competition drove the companies to commit to extremely high levels of local content –the average commitment in the development phase increased from 40 per cent in the Third Round to 90 per cent in the Sixth Round in 2004.

In 2007 the government introduced a new local content certification process. By this process, the operator was required to hire specialized certification companies to prove their compliance with local content commitments. In 2009, the National Petroleum Agency (ANP) introduced a new methodology for local content commitments in the bidding rounds. According to the new rules, operators’ local content offer must detail the numerous products and services expected to be used. For each item, the company has to make a local content offer, respecting a minimum and a maximum value by the ANP.

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Once the very detailed local content commitments are made, companies have few instruments to manage the

risks of overpricing and delays in local purchases. They must undergo a rigorous and complex system of certification of their purchases of goods and services and pay high fines if they do not comply with contractual commitments. The way it is currently structured, Brazil’s local content policy represents a major risk for oil projects.

Impact of local content agreements

To analyse the impact of Brazil’s local content policy on the economic evaluation of projects, from the position of operators focused on offshore oil E&P in Brazil, Diana Martinez-Prieto developed a deterministic model (discounted cash flow) and a stochastic model (Monte Carlo) that simulate the impacts of risks (arising from additional costs, fines, and delays) of not meeting the percentage of the overall local content on a hypothetical project at a field holding 500 million barrels of recoverable oil (Martinez, Diana, 2014, *The Local Content Policy and investment decisions in Brazil*, Master’s Dissertation at UFRJ). The simulations run for a typical oil project (with local content commitment of 37 per cent in the exploration phase and 55 per cent in the development phase) demonstrated that the current Brazilian local content policy has a very significant impact on the project economics. The study simulated the impact of 30 per cent of non-compliance with the local content requirements, as well as 30 per cent additional costs for domestic products than initially anticipated, and a one-year delay in achieving first oil. In this scenario, the likelihood of the project having a negative net present value (NPV) increases from 3 per cent to 47 per cent. This study made it clear that the risks of local content can be economically crippling for many E&P projects.

Even though local policy can clearly have a negative impact on oil and gas investments in Brazil, it also has positive implications. This policy has been effective in increasing the domestic production of goods and services related to the oil industry. The shipyard industry in Brazil, for example, has experienced an important revival in the last 10 years. Brazil already has the fourth-largest offshore fleet and the third-largest shipyard industry in the world. Brazilian dominance in this market will likely grow since there are about 20 floating production, storage, and offloading vessels (FPSOs) under construction and 48 more planned to go on stream by 2025. By 2035 between 75 and 85 new FPSO systems should be added in Brazil. The share of Brazilian-built FPSOs tends to increase as new shipyards currently under construction start to operate. Therefore, the large demand from pre-salt projects and local content policies can help Brazil to become one of the world’s centres for the offshore industry.

Potential improvements to local content policies

Nevertheless, it is fundamental to seek a better balance between the local content incentives and the risks for oil projects. In this sense, it is essential to design and implement mechanisms that allow for greater flexibility in establishing local content commitments. As an alternative to the current process, where the full commitment is established in the bidding round, a more successful model would give space to define and refine local content targets in connection with the preparation of the production development plan. Thus, the company could make feasible commitments based on the best knowledge of its goods and services needs and the context of supply in the domestic market.

When including local content as an important dimension of the field development plan, the ANP would strengthen its monitoring capacity, as it would know the local content strategy of the concessionaire. Moreover, the ANP would better understand the local industry goods and services bottlenecks, empowering itself to address the task of assessing applications by companies for exemptions from commitments for local purchases due to lack of competitive offerings, as provided by the legislation.

The logic of the current local content policy is to punish those companies that do not comply with minimum requirements. However, outcomes could be improved by the introduction of new incentive mechanisms – strengthening local content policy by granting incentives to companies that exceed their commitments. Several incentive mechanisms

could be considered to encourage concessionaires to seek increasing levels of local content, such as (i) reduction of specific duties; (ii) competitive advantages in the bidding rounds of exploration blocks; (iii) reduction in fines for non-compliance with commitments made in other concession contracts.

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Issues related to current contracts

Finally, it is important to consider the contracts already signed. Many of these contracts have included local content commitment levels that are not attainable and/or result in costs that are too high for E&P projects, given the current context of the goods and services market in Brazil. In this case,

a pragmatic reflection on the best path for the country becomes important. The simple application of high fines for non-compliance will certainly not contribute towards accelerating the development of a competitive goods and services industry in Brazil. Currently, fines must be paid to the Treasury and do not generate benefits for the supplier industry. It is important to have a discussion on how to turn possible contractual penalties into mechanisms that encourage the development of the goods and services industry. Possible fines could turn into investment commitments in the supply chain, including research and development. Similarly, local purchases for projects outside Brazil could be considered for rebates in the commitments of projects in Brazil. Such a mechanism would help to reduce potential fines and promote exports of national goods and services.

